

# **2007 ANNUAL REPORT**

**INVESTSC, INC.**

**TO**

**SOUTH CAROLINA**

**VENTURE CAPITAL AUTHORITY**

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### **InvestSC, Inc. to the South Carolina Venture Capital Authority**

#### **BACKGROUND**

The Venture Capital Investment Act was created by the state legislature in 2005 in order to promote the availability of capital for creating and building business ventures in South Carolina. The Venture Capital Authority was established as an agency within the Department of Commerce to identify and select qualified professional investors who will invest in South Carolina companies. The authority is a seven member board selected by the governor and state lawmakers. In 2007 the authority received financing by a private institutional lender secured by state tax credits. Four venture capital firms were then selected to make investments within the state. It is anticipated that the returns from these ventures will be sufficient to repay the lenders without having to utilize the tax credits. When managed successfully, South Carolina is positioned to benefit from economic growth without added state expenditure.

InvestSC, Inc. was formed by the South Carolina Jobs-Economic Development Authority at the specific request of the Venture Capital Authority. The authority selected InvestSC to serve as a "Designated Investor Group" for the purpose of assisting the authority in meeting the goals and objectives of the Venture Capital Investment Act. InvestSC was organized in 2007 as a nonprofit corporation and received 501(c)(3) tax-exempt status approval from the Internal Revenue Service.

#### **INVESTMENT PORTFOLIO**

The South Carolina Venture Capital Authority solicited and received proposals from fifteen private equity firms. The VCA Board performed its due diligence by conducting research into the background, financial capacity and business operations of the interested firms. The strategy was to maximize investment return and minimize portfolio risk by creating a balanced investment stage portfolio. The funds selected target specific sectors that currently exist in South Carolina and can take advantage of clusters that represent state strengths. Each of the funds is made up of successful investment professionals who have previously invested in South Carolina and have established a presence here.

**Noro Moseley:** Founded in 1983, Atlanta-based Noro-Moseley Partners ("NMP") is one of the largest and most experienced venture capital firms in the southeast. Since its inception, NMP has invested in about 160 companies through funds totaling \$580 million in capital. In 2000, NMP announced the closing of NMP V, their fifth fund totaling \$320 million, the largest ever in the Southeast.

NMP invests primarily in Southeastern-based, early and established growth stage companies. This includes companies in various stages of maturity from first round financings to established companies looking for capital. Their focus industries include technology, healthcare and business services. Prior sample investments include SecureWorks, NovaVision, OpenSite, and PGA Golf and Superstore.

**Nexus Medical Partners:** Nexus Medical Partners is a private equity firm, headquartered in Boston, MA, with an office in Charleston that specializes in various stages of development. Specific companies include those in medical devices, diagnostics, biotechnology, specialty pharmaceutical and drug discovery tools. They prefer to lead their investments and to work in a hands-on manner with portfolio companies, committing multiple partners to each investment.

Each of the Nexus Principals averages twenty years in the business and has had successful careers in the medical device and pharmaceutical industry. They have helped to launch some of the top companies in medical technology and life sciences. Prior sample investments include Genentech, Biogen, Cyberonics, and Regeneron Pharmaceuticals.

**Frontier Capital:** Frontier Capital is a Charlotte-based private equity investment firm that provides expansion capital to high growth business services companies. These companies typically utilize technology, an innovative business process, or a unique expertise to deliver a differentiated service to their customers and would include specialties such as IT, software, marketing, healthcare services, outsourcing and communications. They have a proven solution in the marketplace and need capital to accelerate growth.

Frontier has a team of professionals with both extensive investment experience and a broad network of established business relationships. This team is complemented by a small group of former CEO's (such as from First Union CEO Ed Crutchfield) and Senior Executives who serve as Operating Partners. Prior sample investments in South Carolina include LURQH in Myrtle Beach and RJM in Easley.

**Azalea Fund:** Azalea Capital, headquartered in Greenville, SC, is a merchant banking firm providing strategic equity capital to privately owned, middle-market firms in the Southeast. Partnering with management teams in scalable, operating companies with established revenues and cash flows, Azalea provides both financial and human capital to significantly enhance the long-term equity value of the underlying business.

Collectively, Azalea Principals have over 100 years combined experience in business and finance. Their Principals, Advisory Board, and investor base, consisting predominantly of CEOs and former CEOs, bring a wealth of knowledge and experience in a diverse spectrum of industries including manufacturing, distribution, business services, consumer products, and healthcare. Prior sample investments in South Carolina include Horizon CNC Products, Spartan Foods, Power Equipment Maintenance, ISO Poly Films and Tekgraf Corporation.

## **FINANCING**

The Venture Capital Authority Board approved DBAH Capital, LLC (Deutsche Bank) as a lender under the Act and received approval from the State Budget and Control Board. On June 22, 2007, InvestSC and DBAH signed a Securities Purchase Agreement for \$50 million in notes. The notes are secured by all of the investments and tax credit certificates issued by the authority. At closing, the first draw of \$15 million was made on the notes. The remainder must be drawn during the next three years. Interest is payable semi-annually at a fixed rate of 7.247%. Annual principal payments of \$12,500,000 will begin in 2019 until the notes are paid off on June 22, 2022.

The notes require the establishment of three reserve funds as follows: interest reserve, tax reserve and premium reserve funds. The required interest reserve is equal to the semi-annual interest payment that would be due assuming the maximum aggregate principal amount of notes was outstanding. The tax reserve was released during October 2007, since InvestSC received notification from the Internal Revenue Service that it is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code. The premium reserve is a computed amount as required by the “Premium Account Control Agreement”. At December 31, 2007, the interest reserve and premium reserve totaled \$1,911,435 and \$1,146,861, respectively.

## **IMPLEMENTATION OF INVESTMENT PLAN**

The InvestSC Board has approved the funds selected by the South Carolina Venture Capital Authority and verified that each fund’s investment plan provides for the investment in “South Carolina based companies” as provided in the Act. The Venture Capital Authority authorized investments in the following four funds:

Noro-Moseley Partners VI, LP - \$10 Million commitment  
Nexus Medical Partners II, LP - \$20 Million commitment  
Frontier Fund II, LP (Frontier Capital) - \$8 Million commitment  
Azalea SC Fund, LP (Azalea Capital) - \$10 Million commitment

**Noro-Moseley Partners VI, LP:** The limited partnership subscription agreement was executed by InvestSC on June 8, 2007. The final closing for the fund was April 2008 in the total amount of approximately \$119 million. The initial capital draw of \$1,000,000 (ten percent of commitment) was funded by InvestSC on September 28, 2007. There were no additional capital calls by December 31, 2007. The partnership agrees to make investments in South Carolina based companies as required by the South Carolina Venture Capital Investment Act at least equal to the amount invested in the fund. Investments were made by the fund in the following companies during 2007: FrontStream Payments (Nashville), Gateway One Lending and Finance

(Atlanta) and Vocalocity (Atlanta). There were no investments in South Carolina based companies at the end of 2007.

**Nexus Medical Partners II, LP:** The limited partnership agreement was executed by InvestSC on July 5, 2007. The initial capital draw of \$5,000,000 (twenty-five percent of commitment) was funded by InvestSC on July 6, 2007. There were no additional capital calls by December 31, 2007. InvestSC is the only investor in this fund and all investments will be in South Carolina based companies. Nexus expects to bring in additional partners on all of its South Carolina investments, creating a multiplier of three to four times the InvestSC investment. There were no investments as of December 31, 2007.

**Frontier Fund II, LP:** The limited partnership agreement was executed by InvestSC on September 21, 2007. The fund was closed that day with total subscriptions of \$115 million. The initial capital draw of \$1,200,000 (fifteen percent of commitment) was made by InvestSC on September 24, 2007. There was an additional capital call of \$800,000 on December 6, 2007 making InvestSC's total investment in the fund \$2,000,000 (twenty-five percent of commitment) as of December 31, 2007. The partnership agrees to make investments in South Carolina based companies as required by the South Carolina Venture Capital Investment Act at least equal to the amount invested in the fund. Investments were made in the following companies through December 31, 2007: Conclusive Marketing (Nashville, TN), Ryla Teleservices (Atlanta), M3 Technology Group (Charlotte), and Inclinux (Wilmington, NC). There were no investments in South Carolina based companies at the end of 2007.

**Azalea SC Fund, LP:** The limited partnership agreement was executed by InvestSC on September 28, 2007. The initial capital draw of \$1,000,000 (ten percent of commitment) was made by InvestSC that day. There were no additional capital calls by December 31, 2007. InvestSC is the sole investor in the Azalea SC Fund, which is a side fund to the Azalea II Fund. Azalea SC Fund is a one third participant in all South Carolina investments made by the Azalea II Fund. Investments were made in the following South Carolina based companies through the end of 2007: Spartan Foods of America (Spartanburg) and Horizon CNC Products (Travelers Rest). Both of these were ad-on investments in their Azalea II Fund portfolio in which the Azalea SC Fund participated. The InvestSC investment was \$622,050 in Spartan Foods and \$82,500 in CNC Products.

## **TAX CREDIT CERTIFICATES**

The South Carolina Venture Capital Authority Board has issued its initial tax credit certificates and its blank tax credit certificates, as contemplated by the Venture Capital Investment Act, to serve as a source of security for the payment of principal and interest under the terms of the Securities Purchase Agreement with DBAH Capital, LLC. It is anticipated that these tax credits will be sold to companies with South Carolina tax liabilities. The tax credit

certificates can be used to pay state income taxes, bank fees, insurance premium taxes or other tax liabilities. These certificates are held in trust by a custodial bank until such time that they must be exercised. No tax credit certificates have been issued as of December 31, 2007. It is not anticipated that any tax credit certificates will be issued in 2008.

## **EXPENSES**

InvestSC, Inc. was organized on March 1, 2007 and began operations on June 22, 2007 upon execution of the Securities Purchase Agreement as mentioned above in the Financing section. There were significant costs associated with the note issuance, structuring of the transaction, and legal fees. InvestSC paid all the fees for itself, the Venture Capital Authority and the lender from the initial proceeds of the loan. These fees totaled \$1,103,500 and are to be amortized over the 15 year term of the notes.

For the period ending December 31, 2007, interest expense on the notes was \$579,760, note commitment fees were \$55,125 and interest earned on all deposits was \$174,234 for a net investment expense of \$460,651. General administrative expenses for the period were \$112,104. In addition, the amortized portion of the note issuance costs was \$36,783. A schedule of the expenses expressed as a percentage of the fair value of assets on December 31, 2007 is shown below:

Total Assets on December 31, 2007	\$14,427,372
Less, Note Issuance Costs, net	<u>(1,066,717)</u>
Fair Value of Assets	\$13,360,655
Investment Expense for period 6/22/07 to 12/31/07	\$460,651
As a percentage of fair value of assets	3.45%
General Administrative Expense for period 6/22/07 to 12/31/07	\$112,104
As a percentage of fair value of assets	0.84%

## **RATES OF RETURN**

There were no investment returns during the first six months from the funds. All of the funds expect to draw down their capital during the first few years before selling investments and returning capital. The funds drew capital as expected during 2007.

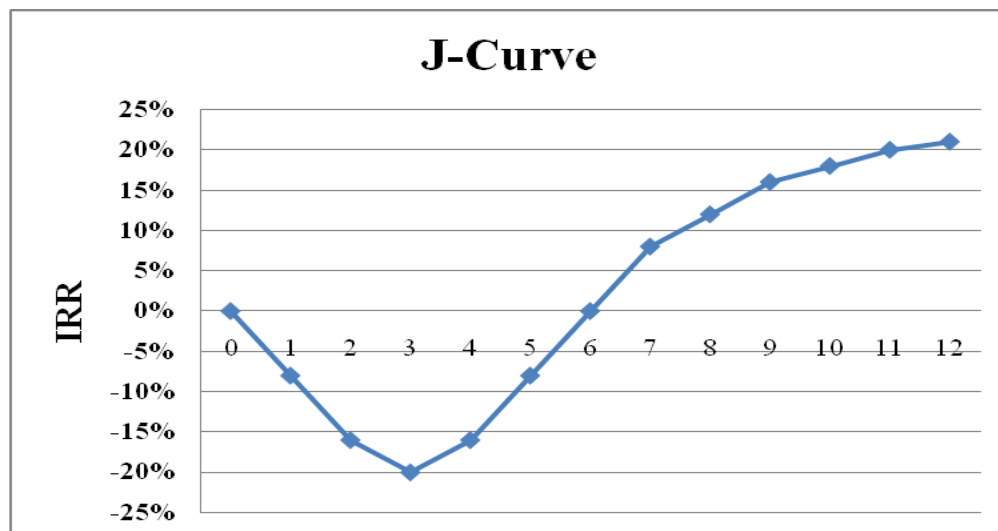
Reviewing the performance of a venture capital fund on a year to year basis provides no meaningful insight into total fund performance, because venture funds typically show a negative return for the first few years of their life. This is entirely natural and will be true even of the very

best venture funds, since the pattern of cash flows (negative in the early years, positive in the later years) produces a “J” curve.

The “J” curve shows a fund’s internal rate of return (IRR, or simply the compound annual return to date) charted against the financial years of a venture fund. Venture capitalists typically commit their funds over the first few years and draw down monies to the underlying companies against these commitments over several more years. It may take several years for VCs to realize their investment in a typical start-up company, based largely on the time needed for these companies to prove their products in the market, and on the availability of suitable exit opportunities (trade sale, IPO, etc.). The above two factors inevitably result in a negative IRR for the first several years of a fund as cash goes out as investments, but has yet to come back by way of realizations. See the “J” curve illustration below.

By the second half of a fund’s life, investments are being realized and annual returns are generally high, compensating for the negative early years and hopefully resulting in a good overall performance compounded annually over the life of the fund. When looking at venture returns, it is therefore important to note the following:

- The first few years or so give little, if any, indication of final returns
- The annual return over any single year is relatively meaningless
- The IRR over the life of the fund is the real measure of a fund’s success



Source: Mowbray Capital